

Written Statement to the Internal Revenue Service (IRS) Oversight Board

How Correspondence Audits Can Be More Effective for the IRS and Less Burdensome for Taxpayers

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Mr. Chairman, thank you for the opportunity to participate in this year's panel discussion on Internal Revenue Service (IRS) correspondence audits. Each year, the IRS identifies billions of dollars in additional income taxes owed through examinations of individual income tax returns. These examinations, which cover a variety of compliance issues, are critical to the IRS's enforcement strategy for ensuring that individuals are paying the amount of taxes owed. Examinations of individual income tax returns range from reviewing tax returns and resolving questionable items by corresponding with taxpayers through the mail to conducting a detailed, face-to-face examination of a taxpayer's financial records at his or her place of business.

In contrast to the more labor-intensive face-to-face examination process, the correspondence examination process is less intrusive, more automated, and conducted by examiners who are trained to deal with and focus on less complex tax issues. Correspondence examinations also enable the IRS to reach more taxpayers at a lower cost. Because improving services to taxpayers is one of the IRS's highest priorities, it is critical for the IRS to understand and minimize the burden (time and costs) that taxpayers spend dealing with correspondence audits.

TIGTA recognizes, as IRS researchers have reported, that measuring taxpayer burden is inherently challenging because it can mean different things to different types of taxpayers (e.g., wage earners versus sole proprietors) depending on whether one is seeking advice about a particular IRS notice, preparing a tax return, or dealing with an IRS field, office or correspondence audit.

To estimate the burden taxpayers are incurring during a correspondence audit, the IRS has sent questionnaires to samples of taxpayers after their correspondence audit closed. The questionnaire asked taxpayers whether they used a tax professional to assist in the audit and to rate their level of satisfaction with respect to the:

- initial IRS contact letter and subsequent notices requesting records,
- amount of time it was taking the taxpayer to get through to the IRS on the telephone,
- overall length of the process,
- tax and business knowledge of IRS employees,
- the courtesy and professionalism of IRS personnel, and
- IRS's consideration given to the information the taxpayer provided during the audit.

As part of the IRS's efforts to monitor and improve taxpayer satisfaction with the customer service provided, a consulting firm compiled and presented results in a July 2011 report from surveying a national sample of taxpayers audited through correspondence. The report showed that approximately 48% of taxpayers were satisfied with the service they received during the correspondence audit, providing an overall satisfaction rating of *somewhat satisfied* or *very satisfied*. While taxpayers indicated they were most satisfied with the courtesy and professionalism of IRS employees, the source of greatest dissatisfaction can largely be attributable to the amount of time it takes to get through the process. For example, the top three areas of dissatisfaction involved the time spent on the audit, the ease of getting through to the IRS on the phone for help, and the overall length of the audit from start to finish. The survey results suggest that the IRS needs to streamline the process so it becomes less time consuming for taxpayers. Some of the comments received from respondents indicated IRS requests for supporting documentation were not clear, asked for information that had already been provided, and/or took too long – sometimes up to a year – to resolve an issue.

One noteworthy action the IRS has taken to reduce taxpayer burden and address the dissatisfaction is by implementing the Intelligent Contact Management System (ICMS) into the correspondence audit process. The implementation of ICMS during Fiscal Year 2010 takes advantage of modern technologies by using a skill-based call routing system to link the 5 IRS campus sites into a single “virtual” call center. Specifically, one toll free number routes calls to the next available assistor who has the appropriate skills to address the call, regardless of where the assistor and taxpayer are located. Importantly, the system is expected to provide taxpayers with the ability to immediately speak to an assistor that is familiar with their type of audit and reduce the number of repeat contacts. Providing taxpayers with the ability to speak to an assistor on the first call and reducing call backs has the potential to go a long way towards making the process more responsive and less burdensome for taxpayers. Under the IRS's old toll-free system, the IRS found that:

- 70% of calls to assigned examiners were answered by voicemail and there was no monitoring process in place to ensure calls were returned;
- 62% of callers were repeat callers and 27% of these were from taxpayers wanting to know if the information they mailed was received; what information was needed, or if their documentation was sufficient.
- 13% of callers phoned more than 8 times before their issue was resolved.

We are in the midst of evaluating the progress the IRS is making to take advantage of the opportunities the ICMS offers for enhancing the correspondence audit process. We expect to issue our audit report later this fiscal year.

Given the apparent high return from correspondence audits, it is not too surprising that auditing taxpayers through the mail is increasing. In Fiscal Years 2004 through 2008, for example, IRS statistics show it conducted more than 5.1 million correspondence examinations and, in the process, recommended approximately \$35 billion in additional

taxes. This represents about 60 percent of the estimated \$58 billion in total recommended additional taxes from all individual examinations during these years. Statistics indicate that for each tax return examined, a correspondence examination generated about \$6,800 in recommended additional taxes. While the additional taxes recommended from these audits are substantial, the increased use of correspondence audits is not without risks. For example, TIGTA has found that substantial noncompliance can go undetected, particularly in audits of taxpayers with income that is subject to little or no information reporting, such as those with income from self employment (i.e., sole proprietors). In a 2010 audit report, TIGTA documented a key reason for this risk citing that, unlike procedures for face-to-face audits, the procedures for correspondence audits do not require examiners to conduct minimum probes for unreported income even though the largest portion of the annual gross tax gap for 2001 and 2006 was due to individuals underreporting income that was subject to little or no information reporting.

During this review, we evaluated a statistically valid sample of 298 correspondence audits and identified 93 where business expenditures and other items deducted on the return that, when combined with estimated personal living expenses, exceeded the income on the return by more than \$10,000. In 15 of these 93 instances, our cash transaction analyses indicated that the expenses exceeded the income on the return by more than \$50,000. The considerable differences noted between expenditures and income elicit very serious questions about whether expenses on the return are overstated or if there were additional sources of income that should have been reported on the returns. We also identified 114 audits out of the 298 audits reviewed where sole proprietors may not have been entitled to the refunds they received from earned income credits if the significant differences we noted between the expenditures and income were, in fact, caused by overstating expenses and/or underreporting income.

TIGTA has additionally found that accuracy-related penalties were not properly considered and recommended during correspondence audits. Such penalties are critical because, according to the IRS, they are designed to promote voluntary compliance by imposing an economic cost on taxpayers who choose not to comply with the tax law. Despite their importance to compliance, TIGTA reported in Fiscal Year 2010 that accuracy-related penalties were seldom being properly considered by the IRS. Specifically, TIGTA reviewed 229 correspondence audits and identified 211 audits where an accuracy-related penalty appeared warranted but was not applied. Each of the audits we reviewed resulted in the taxpayer agreeing he or she owed additional taxes of at least \$5,000. The \$5,000 threshold is important to emphasize because it allowed us to review cases where examiners were required to consider assessing an accuracy-related penalty. Furthermore, the IRS officials who reviewed our work agreed with our conclusions.

For example, in 19 audits, taxpayers could not substantiate their employee business expenses and were assessed additional tax of \$137,617. In another 43 audits, taxpayers agreed that they omitted more than \$356,210 in alternative minimum taxes when they filed their tax returns. Although the IRS considers the substantial

overstatement of deductions a potential fraud indicator, there was no documentation that indicated that the manager and examiner developed an action plan in the case files, as required. Overall, we estimated that, as a result of the accuracy-related penalties not being properly considered and assessed, the IRS was at risk of missing the opportunity to promote compliance among some 9,200 taxpayers and enhance revenue by \$17.5 million.

To better ensure accuracy-related penalties are properly considered during correspondence audits, TIGTA made two recommendations in a July 2010 report that the IRS agreed to implement. First, we recommended that appropriate IRS officials make certain that planned training is completed by all correspondence examiners and their managers, and that the training specifically addresses when the accuracy-related penalty is applicable, how case files should be documented, and when managerial approval is required. We also recommended that the directors require managers and examiners to properly complete the accuracy-related penalty lead sheets for all applicable audits.

On a more positive note, and in closing, the IRS has, to its credit, successfully expanded audit coverage using the correspondence audit process. Such expansion benefited the taxpaying public because it helps to strengthen the public's respect for the system by helping ensure all individuals are paying the amount of taxes they owe. The IRS uses correspondence audits as a key tool to remedy the noncompliance that contributes to the tax gap, which is estimated to be costing the Federal Government \$450 billion annually, and is considered by many to be one of the most serious problems facing tax administration today.

Chairman Cherecwich and Members of the Board, thank you for the opportunity to provide TIGTA's perspective on how correspondence audits can be more effective and less burdensome for taxpayers. I would be pleased to answer any questions you may have at the appropriate time.